LAHAD DATU TIMBER SDN. BHD.

v.

DIRECTOR-GENERAL OF INLAND REVENUE

PRIVY COUNCIL
LORD DIPLOCK
LORD RUSSELL OF KILLOWEN
LORD KEITH OF KINKEL
LORD BRIDGE OF HARWICH
JOHN MEGAW
[PC APPEAL NO. 28 OF 1978]
29 APRIL 1981

REVENUE LAW: *Income tax - Additional assessment - Timber operation - "Agency fee" - Whether chargeable to timber profits tax - Sections 20, 19 of the Supplementary Income Tax Act 1967 (Act 54 of the Laws of Malaysia) - "Development cost", "planting payments" and "commission" - Whether deductible - Section 39(1)(g) Act 53 - Adjusted income - Section 33(1) Act 53.*

This was an appeal against the additional assessment which the respondent had imposed on the appellant, in respect of alleged profits which the appellant had allegedly made from its timber-based business in the year 1968. The facts showed that in 1966 the appellant entered into two separate agreements with the Ulu Tengku Co-operative Land Development Society Ltd. (the Society), the concessionaire of a timber concession in Sabah, whereupon the appellant undertook, by the first agreement, to extract timber from the concession and deliver them to a specified log pond, and by the second agreement, to sell and export the timber on behalf of the Society. It was not in dispute that by these agreements the appellant also undertook to exercise the Society's rights and perform the Society's obligations, and in exchange for that, would pay the Society cash considerations based on the volume in cubic foot of timber extracted, sold and exported.

Having executed the agreements aforesaid, however, the appellant entered into an agreement with one Yong Brothers whereby the appellant subcontracted some of its obligations to the Society to the said Yong Brothers. Following this, for a certain cash consideration, Yong Brothers, at their own expense, proceeded to fell the timber and remove them to the log pond.

The appellant's accounts for the basis year of 1968 showed that the appellant had earned some RM 1,789,645 from its timber sale. It was not in dispute that out of this figure, the respective sums of RM 140,175, RM 201,000 and RM 158,000, *inter-alia,* were meant for payment of (i) fixed commission to the Society (ii) Planting payments and (ii) Development costs. The Special Commissioners found that the figure of RM 1,789,645 aforesaid, including the said sums of RM 140,175, RM 201,000 and RM 158,000, were proceeds of sale and are not therefore deductible for the purpose of timber tax by virtue of the provision of s. 39(1)(g) of the Income Tax Act 1967. This finding of the Special Commissioners was reversed by the High Court but was reinstated on further appeal to the Federal Court. This is the appellant's appeal.

Before the law Lords herein, two main questions arose for consideration namely:

(i) Whether the interest of the appellant in the proceeds of sale enters at all into the ascertainment of its income derived from timber operations.

(ii) Whether the three items disallowed as deductions by the Special Commissioners come within s. 39(1)(g) of the Income Tax Act 1967.

Held:

Per Lord Russel of Killowen

[1] The two agreements can only be regarded as interdependent and must be read as one integral bargain between the two parties. It would seem that the device of two agreements instead of one was an attempt to minimise the incidence of timber profit tax.

[2] The appellant's contention that timber operation is confined only to the extraction of timber, and that the proceeds of sale should therefore be apportioned in order to ascertain how much of them should be properly labelled income derived from timber operations, cannot be sustained. Their Lordships do not perceive upon what basis that could be done. The whole purpose and function of timber extraction is to turn it into account by export and sale. Their Lordships therefore cannot accept the view that income derived from timber extraction is so narrowly to be construed as to exclude income from sales of which the extraction is a *sine qua non.*

[3] In the instant case, the appellant by its contract with the Society took over the position of the Society, and in exchange agreed to pay the stated commission to the Society. Equally, it appears to their Lordships, the proceeds of sale of the timber to which the appellant became entitled are aptly described as income derived from timber operations.

[4] The three items disallowed as deductions by the Special Commissioners are caught by s. 39(1)(g) of the Income Tax Act 1967. They fall squarely within the description of sums payable for the use of a licence or permit to extract timber, within the statutory provision.

[Appeal dismissed.]

Legislation referred to:

Income Tax Act 1967, ss. 33(1), 39(1)(g), 140, (5)
Supplementary Income Tax Act 1967, ss. 19, 20

For the appellants - Andrew Park QC (S. WoodhuIl with him); M/s. Slaughter & May
For the respondents - Patrick Medd QC (David Railton with him); M/s. Stephenson Harwood

JUDGMENT

Lord Russell of Killowen:

The appellant company ("the taxpayer") received in July 1971 and December 1973 notices of additional assessment in respect of the year 1969, based on profits in the year 1968. The taxpayer appealed against the assessment to the Special Commissioners who in July 1974 dismissed the appeal. On appeal to the High Court of Borneo (Yusoff J) on a case stated by the Special Commissioners the taxpayer's appeal was in June 1976 allowed. On appeal therefrom by the Inland Revenue the Federal Court of Malaysia (Lee Hun Hoe CJ Borneo, Ong FJ and Ho J) in December 1977 allowed the appeal and reinstated the decision of the Special Commissioners. The taxpayer now appeals from that last order to His Majesty the Yang di-Pertuan Agong.

The issues arising on the appeal concern the questions (a) Whether a sum of RM303,313 described in the taxpayer's accounts as "agency fee" was chargeable to timber profits tax under the Supplementary Income Tax Act 1967 (Act 54 of the Laws of Malaysia) and (b) Whether three sums of RM158,000, RM201,000 and RM140,175 so described as, respectively, "development cost", "planting payments" and "commission" were allowable deductions in the ascertainment of the adjusted income of the taxpayer from timber operations.

The statutory provisions to be borne in mind when considering this appeal are the following:

Section 33(1) of the Income Tax Act 1967 (Act 53 of the Laws of Malaysia)

> Subject to this Act, the adjusted income of a person from a source for the basis period for a year of assessment shall be an amount ascertained by deducting from the gross income of that person from that source for the period all outgoings and expenses wholly and exclusively incurred during that period by that person in the production of gross income from that source ...

Section 39(1)(g) of the Act 53

> Subject to any express provision of this Act, in ascertaining the adjusted income of any person from any source for the basis period for a year of assessment no deduction from the gross income from that source for that period shall be allowed in respect of ... (g) any sum, by whatever name called, payable (otherwise than to a State Government) for the use of a licence or permit to extract timber from a forest in Malaysia ...

Sections 20 and 19 the Act 54

> 20. A supplementary income tax (to be known as timber profits tax) shall be charged for each year of assessment upon the income of any person derived from timber operations at the rates specified in this Part and shall be additional to the income tax (if any) charged in respect of that person for that year of assessment under [Act 53]
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> 19. In this Part (i.e. Part IV headed Timber Profits Tax) unless the context otherwise requires:
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> 'timber operations' means the extraction of timber from a forest in Malaysia or the granting or assignment of any rights, privileges, licences or concessions (by whatever name called) for the extraction of such timber but does not include the processing, milling, sawing or manufacturing of the timber.
>
> 'income derived from timber operations' includes all premiums, rents and tributes (by whatever name called) derived from timber operations, or from the granting or assignment of any rights, privileges, licences or concessions (by whatever name called) for the extraction of timber from a forest in Malaysia.

The above statutory provisions were the only ones to which the attention of their Lordships was called by Counsel for the taxpayer as material to the issues in this appeal. Counsel for the Inland Revenue was not called upon.

The extraction of timber for export sale is a very important aspect of the local economy. The timber trees when felled, in often remote forest areas, are sawed into manageable logs for transport by one means or another to log ponds at the sea, whence they are removed to ships for export. (Counsel for the taxpayer disclaimed any suggestion that such sawing was within that word as used in the quoted definition of timber operations.) Extraction of timber from a forest in the limited sense of felling a tree and moving it to a point outside the limits of that forest is not an end in itself: its only purpose is to achieve the sale of the timber: it is to that end that logs formed from the timber are transported sometimes many miles to a suitable log pond and then to a ship.

In early 1966 a parcel of State land of 4364 acres was alienated by the State to the Ulu Tungku Cooperative Land Development Society Ltd. ("the society") for the purpose of agricultural development, and at the same time the Society was granted by the State Government a timber licence to extract, remove and sell the timber, the society to apply the proceeds to development of the alienated land. In September 1966 the society entered into an agreement with Dato' Donald Stephens and Abdul Majid Khan bin Haji Kalakhan: this was not produced before the Special Commissioners (though the latter gentleman gave

evidence) and the only knowledge of it - incomplete - is that it is referred to as a "timber extraction" contract in a paragraph in the objects clause of the taxpayer, which paragraph indicated that it was an object of the taxpayer to take over the position of the two named gentlemen under the contract. They in December 1966 caused the incorporation of the taxpayer. In the event it seems that that object clause was not pursued, though it cannot in their Lordships' opinion be doubted that in some shape or form and on some terms the missing contract provided for both extraction of felled timber and sale of the resultant logs.

The missing contract not having been taken over by the taxpayer, it was cancelled by clause 11 of the first agreement next mentioned: it was there referred to as an agreement entered into with the taxpayer. The first agreement was signed by Stephens and Majid Khan on behalf of the taxpayer. The society and the taxpayer instead entered into two agreements dated 13 June 1967.

One agreement was referred to as an agreement for the extraction of timber for part of the land alienated to the society. It was agreed that the society should permit the taxpayer to fell and cut timber from specified blocks and to remove the timber to a log pond to be agreed. The taxpayer (described as the contractor) was to be paid by the society RM1 per cubic foot as soon as measured by the Forest Department and delivered to the log pond. Access to the land was to be afforded by the society to the taxpayer for the purpose of the latter's operations. Clause 8 provided that the agreement might be terminated by the taxpayer giving one month's notice to the society. Extraction was to be completed within 4 years.

The second agreement was referred to as an agreement for timber export and the execution of certain works. It recited that the society was desirous of entering into an agreement with the taxpayer "for the sale of the timber on the society's behalf and for certain works to be undertaken in the development of the land". It was agreed that the society would permit the taxpayer to "sell and export on behalf of the society all timber extracted and delivered at an agreed log pond". Clause 2(1) put upon the taxpayer the responsibility of keeping the log pond in order, and of receiving and of custody of timber therein, and for the transport of the timber therefrom to ships. Clause 2(2) bound the taxpayer to "pay for the timber extracted and delivered to the log pond as may be due to any contractor from the society". Their Lordships recall that the taxpayer was itself the contractor entitled to RM1 per cubic foot delivered to the log pond, so this clause and the first agreement are in that regard self-cancelling. Clause 2(3) required the taxpayer to pay any royalty due to Government in respect of the timber. Clause 3 made it the duty of the taxpayer to find the best markets for sale and export of the timber and to negotiate with buyers for the best price either in the name of the society or of the taxpayer. Clause 5 required the taxpayer to execute works specified in the Schedule at the locations specified in the attached development plan at costs not exceeding those mentioned in the Schedule: these works included road construction, construction of houses, of a school, of a teacher's quarters, of a community centre, of staff quarters, of a playing field ("padang"), and of a rest house. The total cost was some RM630,000. It cannot be doubted that this was to meet the obligations of the society under the conditions of the alienation and licence to the society. The agreement does not specifically state that the taxpayer was to bear the cost of these works, but it was (rightly) assumed on all hands that it was to. Clause 9(1) required the taxpayer to pay to the society or to a contractor for the society RM587,000 by instalments not exceeding RM198,000 in any one year: these payments were to cover the assessed costs of planting part of the area with coconuts and cover crops, of maintenance of the

planted area for 6 months, and for twelve miles of fencing. These no doubt were obligations of the society under the state alienation and licence to it. Clause 9(2) required the taxpayer to pay to the society within one month of timber being sold and exported either 21 cents or 5 cents per cubic foot depending on girth. Clause 10 repeated the provisions for determination contained in the other agreement. Clause 13 gave the agreement a period of 4 years and contained a proviso "that if there is delay in the extraction and delivery of timber at the log pond and in the execution of any work under this agreement, which could not have been reasonably avoided by the contractor" an extension of the 4 years might be permitted - a direct link with the other agreement.

Their Lordships are of the clear opinion that these two agreements can only be regarded as interdependent and must be treated as one integral bargain between the two parties. (Indeed it is recited in the sub-contract dated 28 June 1967 between the taxpayer and Yong Brothers later mentioned that the taxpayer "has a contract to extract and sell timber".) It would seem likely that the device of two agreements (at an extra cost of RM5) instead of one was an attempt to minimise the incidence of timber profits tax. (In that connection it was accepted before their Lordships, though not below, that the tax avoidance provisions of s. 140 of the Act 53 were not available to the revenue for lack of requisite notices under subsection (5)).

Counsel for the taxpayer, while saying that if there had truly been two separate agreements his contentions might have been easier (or less difficult), said that they were nonetheless valid had there been only one document containing the whole of the arrangements between the taxpayer and the society. The theme of his contentions was that extraction is one thing and selling extracted timber was another for the purposes of the relevant fiscal legislation.

What in summary was the contract between the taxpayer and the society? It was in their Lordships' opinion this. The society had from Government the right to extract and sell timber from the designated areas, subject to obligations as to construction, planting and fencing already mentioned. The society and the taxpayer agreed (without formal assignment of the Government licence) that the taxpayer should, directly or indirectly, exercise the society's rights and perform the society's obligations in exchange for payment by the taxpayer to the society of 21 cents (or 5 cents) per cubic foot of timber extracted, sold and exported. Nothing was to be paid by the society to the taxpayer for the work of extraction, for the RM1 per cubic foot was self-cancelling. The taxpayer's gross remuneration for its work on extraction, removal to the log pond, maintenance of the log pond, and merchandising was to be the proceeds of sale, less a fixed commission to the society per cubic foot sold, and subject to the obligation to pay for the construction of the scheduled works and to pay to the society (or its nominated contractor) the other sums for planting, etc., by instalments not exceeding RM198,000 yearly, and also the royalty due to the State.

The accounts of the taxpayer for the basis year 1968 showed Proceeds of Sale of 686,775 cubic feet of timber at RM1,789,645. (All fractions are here ignored.) From that figure was deducted a figure of RM1,486,331 leaving a sum of RM303,313 described as "agency fee". The total of RM1,486,331 was made up follows:

(i) Royalty (i.e. to state)	RM300,380
(ii) Fixed Commission to Society	RM140,175
(iii) Extraction fee at RM1 per cubic foot	RM686,775

(iv) Planting payments RM201,000

(v) Development cost RM158,000

Item (iii) above is of course the self-cancelling sum already mentioned: though it is a contra brought into the taxpayer's profits as extraction charges received, a sum which the taxpayer is prepared to submit to timber profits tax. The question is whether the sum of RM1,789,645 (minus the figure for royalty) is for timber tax purposes chargeable from which the figures at (ii), (iv) and (v) are not deductible.

The taxpayer not having the equipment or expertise to carry out its obligations to the society on 28 June 1967 entered into an agreement with Yong Brothers (already mentioned) whereby the taxpayer subcontracted some of its obligations to Yong Brothers. The latter at their own expense were to fell the timber and remove it to the log pond, when they were to receive 82 cents per cubic foot: they were permitted to sell the timber in the log pond as might be agreed with the taxpayer, and were to receive 2 per cent of the proceeds of sale. The Special Commissioners found that the figure of RM1,789,645 mentioned above as proceeds of sale was arrived at after deduction of this 2 percent, and that the figure of RM303,313 should therefore be increased by RM36,651 to RM339,964. Apart from that and from the marginal relevance (see above) of its recital the Yong Brothers' agreement does not afford assistance. It will be noted that the taxpayer's liability to the society to meet construction and planting costs was not passed on to Yong Brothers.

The Special Commissioners found (in effect) that the gross income of the taxpayer from the timber operations was RM1,826,296, proceeds of sale. From this Government royalty was a permissible deduction of RM300,380: if the three figures of "development costs" (RM158,000), "planting payments" (RM201,000) and "fixed commission" (RM140,175) - a total of RM499,175 - were also deductible this would leave a figure of RM1,026,741: but under s. 39(1)(g) of Act 53 they were not. This would leave a figure of RM1,525,916.

There are it appears to their Lordships two questions for solution. The first is whether the interest of the taxpayer in the proceeds of sale enters at all into the ascertainment of its income derived from timber operations. The taxpayer contends that this is not so, and is not so even if the two agreements are to be regarded as one integral agreement. Timber operations, it was contended, is confined to the extraction of timber by felling and removal from the confines of the forest: though the taxpayer was prepared to accept that the RM1 per cubic foot was such income, it was in terms consideration for log ponding as well as removal. Faced with the possible situation that the society in this case might have done its own felling, removal and marketing, it was argued for the taxpayer that somehow the proceeds of sale should be apportioned in order to ascertain how much of them should be properly labelled income derived from timber operations. Their Lordships do not perceive upon what basis that could be done. The whole purpose and function of timber extraction is to turn it to account by export and sale, and their Lordships cannot accept the view that income derived from timber extraction is so narrowly to be construed as to exclude income from sales of which the extraction is a *sine qua non.* Of course if (in the example given) importing purchasers from the society were to sell their rights at a profit, their profit would not be income derived from timber extraction. That profit would derive from turning to good account a contract of purchase of timber. The extraction of timber is only in the background.

In the instant case the taxpayer by its contract with the society took over the position of the society, albeit without an express assignment of the society's rights and obligation against and to Government, and in exchange agreed to pay the stated commission to the society. Equally, it appears to their Lordships, the proceeds of sale of the timber to which the taxpayer became entitled are aptly described as income derived from timber operations.

The second question is whether the three items disallowed as deductions by the Special Commissioners come within s. 39(1)(g) of the Act 53. They have already been described. They appear to their Lordships to fall squarely within the description of sums payable for the use of a licence or permit to extract timber, within that statutory provision.

In their Lordship's opinion the conclusion of the Special Commissioners was correct, and they will advise His Majesty the Yang di-Pertuan Agong that this appeal should be dismissed with costs.

Also found at [1981] CLJ 81